

Gazprom Neft: Medium Oil with a Big Brother

Investment Summary

We resume coverage of Gazprom Neft, the fifth largest and most profitable Russian oil company. Gazprom Neft plans to increase oil production to 80mt in 2020 from current 32.7mt, and ownership of relevant field licenses by the company's parent, Gazprom, make this target realistic. We believe that the company's refining capacities will be sufficient to maintain high margins in the mid-term. We view Gazprom Neft as one of the most attractive Russian oil stocks and recommend investors to BUY. Our fair price is \$7.70 per share, which offers 35% upside from current levels.

- ✓ Gazprom Neft's key growth drivers are plans to substantially increase oil production and ability to maintain highest profitability in the Russian oil sector in the mid-term. Rapid production growth will cause profitability to decline in the longer term (from 24% to 16% by 2016 on our estimate) unless the company maintains its refining ratio by continued expansion of refining business.
- ✓ Planned purchase of a controlling stake in the Serbian oil & gas monopoly (NIS) will add refining capacities, but we do not assume any further additions, and this makes our valuation conservative.
- ✓ Gazprom Neft is a subsidiary of Gazprom, which means that the company bears lower political and administrative risks than most other Russian oils. We believe that Gazprom will create maximum opportunities for its subsidiary.
- ✓ The company was recently included in the MSCI Emerging Markets Index, which reduces illiquidity risks (free-float is only 4.5%).
- ✓ High dividends are an added attraction, which we expect to continue, though large capex needs could lead to their reduction. But debt levels are low, so the company will be able to borrow money to finance part of its capex.
- ✓ We believe that the company will outperform the rest of the Russian oil industry for at least three years, since refining capacities added through acquisition of NIS will be able to process rising crude oil throughput.
- ✓ We view Gazprom Neft as one of the most attractive objects for investment among Russian oil companies. Our fair value per share for the end of 2008 is \$7.70 and our recommendation is to BUY the stock.

SIBN

BUY \$7.70 ▲35%

Current market cap, \$m	27 025
EV, \$m	30 352
Estimated free-float, %	4.5%

Common shares

- ticker (RTS)	SIBN
- number, m	4 741
- bid-ask range, \$	5.55-5.75
- fair price, \$	7.70
- up/down, %	35%
- previous fair price, \$	no

Preferred shares

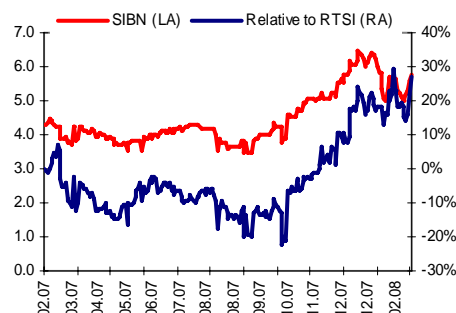
- ticker (RTS)	no
- number, m	0
- bid-ask range, \$	n/a
- fair price, \$	n/a
- up/down, %	n/a
- previous fair price, \$	n/a

Other stock exchanges

LSE (1 ADR = 5 shares)	GAZ
NYSE	N/L

GAAP, \$m	06	07E	08E	09E
Revenues	20 172	20 500	25 321	25 352
EBITDA	5 676	5 820	6 989	7 260
- margin, %	37%	35%	36%	36%
Op. income	4 366	4 429	5 349	5 374
Net income	3 661	4 002	4 697	4 770
- margin, %	24%	24%	24%	24%
EPS, \$	0.77	0.78	0.99	1.01

	06	07E	08E	09E
EV/S	1.5	1.5	1.2	1.2
EV/EBITDA	5.3	5.5	4.3	4.2
EV/FCFF	11.7	16.1	14.6	10.2
P/E	7.4	7.3	5.8	5.7



Operating overview

Gazprom Neft plans to increase oil production by 2.5 times in 12 years

Gazprom's oil subsidiary, Gazprom Neft, plans to increase crude production from current 32.7mt to 80mt by 2020 through exploration and development of oil fields, to which Gazprom now holds rights. We expect Gazprom Neft to start buying licenses from its parent in 2009 and we expect that cost of the licenses will not be high, since Gazprom will have no reason to squeeze its subsidiary.

The company gets cheap oil and refining from Slavneft

In addition to its own production, Gazprom Neft holds a 50% stake in Slavneft (the other 50% is owned by TNK-BP) and purchases crude from Slavneft at about 56% discount to average Urals price, as well as using Slavneft's refining capacities (particularly the Yanos Refinery) on favorable terms. Slavneft showed 10.5% decline of oil production in 2007 and its officials say that it will aim to stabilize production at current levels up to 2013. We expect Slavneft to show further annual output declines of 3-5% thereafter.

In December 2007 Gazprom Neft acquired 50% of Tomskneft from Rosneft. Managers of Tomskneft say that the company will increase output in coming years to achieve a ceiling of 13.3mt by 2011. Gazprom Neft paid a fairly high price for Tomskneft, but we are optimistic that it was justified by value of the asset.

Gazprom Neft exported its crude oil and petroleum products using a trader in 2007, so there was much divergence between market prices and the company's contract prices. However, use of a trader enabled the company to avoid a significant part of export duties and excises.

We note that Gazprom Neft has shown a "re-sale" category in its revenues for recent periods, reflecting crude oil, which the company bought from third parties (not including Slavneft) and re-sold. Benefit from these operations seems to have been very low and we expect the company to scale down this business.

Production and distribution

	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Production and purchases, mt											
Production of Gazprom Neft	32.7	32.7	33.5	37.0	40.4	43.9	47.3	50.8	54.3	57.7	61.2
50% share in Tomskneft	-	-	6.0	6.1	6.3	6.5	6.6	6.6	6.6	6.6	6.6
50% share in Slavneft	11.7	10.5	10.6	10.6	10.6	10.6	10.6	10.4	10.1	9.7	9.3
<i>Purchased from 3rd parties</i>	7.2	5.0	4.8	4.7	4.5	4.3	4.2	4.0	3.8	3.7	3.5
Own consumption, losses, reserves	2.2	2.1	2.3	2.5	2.6	2.8	2.9	3.1	3.2	3.3	3.4
Total, mt	49.3	46.1	52.5	55.8	59.2	62.5	65.8	68.8	71.6	74.4	77.2
Distribution, mt											
Throughput to Omsk Refinery	16.3	16.5	16.7	16.8	17.0	17.2	17.5	18.0	18.5	19.0	19.5
Throughput to Moscow Refinery	3.2	3.3	3.4	3.6	3.7	3.8	3.9	3.9	3.9	3.9	3.9
Throughput to Yanos Refinery	4.7	6.3	6.4	6.6	6.7	6.9	7.0	7.0	7.0	7.0	7.0
Throughput to Yaroslavl Refinery	0.10	0.08	0.08	0.08	0.08	0.08	0.08	0.08	0.08	0.08	0.08
Throughput to NIS (Serbian oil company)				3.2	3.6	3.9	4.3	4.6	5.0	5.0	5.0
Total throughput, mt	24.4	26.2	26.6	30.3	31.0	31.8	32.8	33.6	34.5	35.0	35.5
Total output of petroleum products	20.6	22.3	22.8	26.1	27.0	28.0	29.1	29.9	30.8	31.2	31.7
<i>Overall efficiency, %</i>	<i>84%</i>	<i>85%</i>	<i>85%</i>	<i>86%</i>	<i>87%</i>	<i>88%</i>	<i>89%</i>	<i>89%</i>	<i>89%</i>	<i>89%</i>	<i>89%</i>
Crude oil for export	17.2	14.6	17.9	17.7	19.4	21.2	22.8	24.3	25.7	27.2	28.8
Crude oil for domestic market	7.7	5.3	8.0	7.9	8.7	9.5	10.2	10.9	11.5	12.2	12.9
Total	49.3	46.1	52.5	55.8	59.2	62.5	65.8	68.8	71.6	74.4	77.2
Gas production, bcm	3.0	3.0	3.6	4.0	4.3	4.6	5.0	5.3	5.6	5.9	6.2

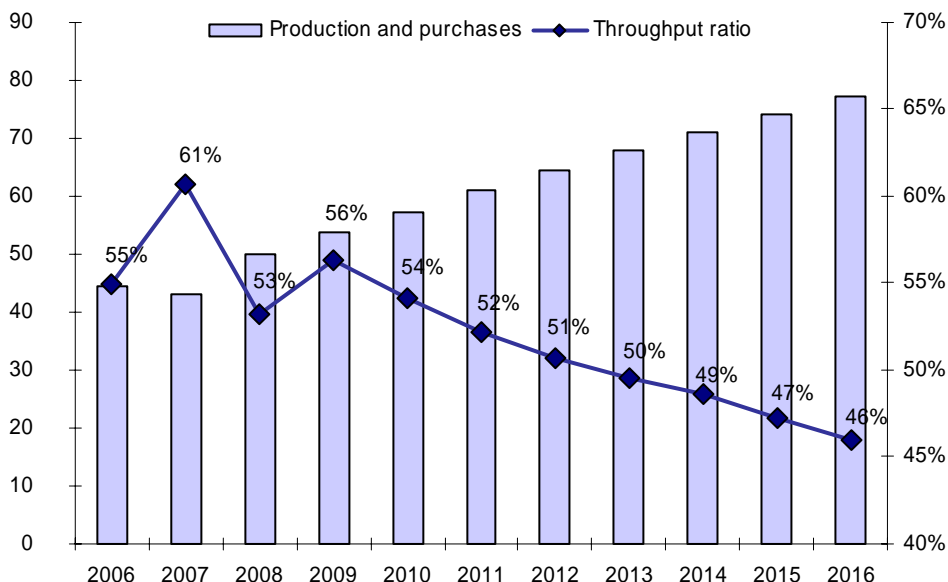
Source: Company data, RMG estimates

A stake in NIS will maintain refining coverage

Gazprom Neft will acquire a 51% stake in the Serbian oil and gas monopoly, NIS, in 2008. The deal will increase company refining capacities by 3.2mt or 12%.

We see strong probability that Gazprom Neft will further expand its refining capacities in 2009-2010, as rising crude output reduces its refining ratio. However, we do not account any such expansion in our model, which therefore becomes more conservative.

Production & purchases vs. refining throughput



Source: Company data, RMG estimates

Financial overview

We expect 24% net margin in 2007-2009

The company showed 24% net margin in 2006 and we expect it to be almost unchanged in 2007. Net margin will remain unchanged in the next two years due to acquisition of NIS with its refining capacities, but will fall thereafter as the refining ratio fails to keep pace with production CAGR of about 6.5%, unless the company obtains more refining capacities.

The jump of sales in 2008 will be due to acquisition of a 50% stake in Tomskneft and expected average Brent prices of \$80/bbl.

The company has an "Other costs" category in its income statement. Since the start of 2007 these have consisted of a part of transportation costs, so we have included them in operating costs.

45% growth of opex in 2006 and 2007 will not be repeated

The company shows operating costs rising by about 45% for two years in a row (2006 and 2007). This considerably exceeds the inflation rate adjusted for ruble appreciation. The cost jump is partly due to increase of refining throughput, but mostly due to the fact that the Moscow Refinery and Yanos increased refining quotas for Gazprom Neft by 60% and 25% respectively in 2007.

The 60% increase of refining tariffs for Gazprom Neft in Moscow is part of Gazprom's (and previously Sibneft's) long-running battle with the Moscow government and affiliated parties for control over the city's Refinery. The increase at Slavneft's Yanos Refinery largely represents a reallocation of cash within Gazprom Neft, since the latter owns half of Slavneft.

The average share of operating costs in total costs in the past two years was about 20%. Historically refineries have not increased their tariffs by much more than adjusted inflation, so we are optimistic that the 45% jumps in operating costs will not be repeated.

Shares in affiliates mainly consist of Slavneft's earnings, which will correlate with crude oil prices as Slavneft will not increase its production in the future.

Revenue calculation

	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Brent price, \$/bbl	65.5	72.0	80.0	73.9	67.9	61.8	63.7	65.6	67.5	69.6	71.6
Urals price, \$/bbl	61.2	69.5	75.9	69.8	63.9	57.8	59.7	61.7	63.6	65.8	67.8
Oil exported, mt	17.2	14.6	17.9	17.7	19.4	21.2	22.8	24.3	25.7	27.2	28.8
Domestic Urals price, \$/bbl	30.0	32.2	33.6	31.1	28.5	26.0	26.2	26.6	27.0	27.4	27.9
Domestic sales, mt	7.7	5.3	8.0	7.9	8.7	9.5	10.2	10.9	11.5	12.2	12.9
less: discount to trader, \$m	-	669	896	815	819	808	899	988	1 077	1 181	1 289
Crude oil sales, \$m	9 422	8 029	11 030	10 037	10 099	9 977	11 051	12 103	13 157	14 385	15 665
Average basket price, \$/t*	491	566	638	602	565	526	552	579	609	640	658
Exported, mt	11.0	9.7	9.7	11.0	11.1	11.3	11.5	11.6	11.7	11.6	11.8
Domestic basket price, \$/t	486	588	652	602	551	499	520	542	564	587	606
Domestic sales, mt	9.6	12.6	13.0	15.1	15.9	16.7	17.6	18.3	19.1	19.6	19.9
less: discount to trader, \$m	-	659	746	792	755	714	764	808	854	891	931
Revenue from PP sales, \$m	10 407	12 220	13 970	14 919	14 303	13 567	14 745	15 851	17 008	18 037	18 876
Revenue from gas sales, \$m	88	110	173	240	335	488	552	619	692	769	815
Other revenues	255	142	149	156	164	172	181	190	199	209	220
Total revenue, \$m	20 172	20 500	25 321	25 352	24 901	24 204	26 529	28 763	31 056	33 400	35 577

* Basket price includes average estimated prices for gasoline, diesel, fuel oil and jet fuel. The re-sales category, which the company showed in its FY 2006 presentation, is distributed between export and domestic sales.

Source: Company data, RMG estimates

Income statement, \$m

	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Sales	20 172	20 500	25 321	25 352	24 901	24 204	26 529	28 763	31 056	33 400	35 577
less: export duties	4 742	3 967	5 860	5 385	5 154	4 809	5 371	5 932	6 502	7 142	7 813
Net revenue	15 430	16 533	19 462	19 967	19 748	19 395	21 159	22 832	24 554	26 258	27 764
Purchases	3 983	3 485	3 767	3 431	3 106	2 782	2 841	2 861	2 855	2 829	2 798
Operating costs	1 775	2 452	3 158	3 701	4 192	4 686	5 203	5 674	6 142	6 596	7 041
SG&A	1 918	2 062	2 472	2 536	2 508	2 463	2 687	2 900	3 118	3 335	3 526
DD&A	803	932	1 119	1 316	1 535	1 782	2 059	2 368	2 717	3 109	3 550
Non-income taxes	2 586	3 174	3 598	3 609	3 560	3 437	3 849	4 294	4 758	5 258	5 778
Total costs	15 806	16 071	19 972	19 978	20 055	19 959	22 010	24 029	26 092	28 269	30 505
Operating profit	4 366	4 429	5 349	5 374	4 847	4 244	4 519	4 734	4 964	5 131	5 072
Operating margin, %	28%	27%	27%	27%	25%	22%	21%	21%	20%	20%	18%
Share in affiliates	507	459	522	570	525	481	436	441	442	438	434
EBITDA	5 676	5 820	6 989	7 260	6 907	6 507	7 014	7 543	8 122	8 678	9 055
EBITDA margin, %	37%	35%	36%	36%	35%	34%	33%	33%	33%	33%	33%
Net income	3 661	4 002	4 697	4 770	4 330	3 834	4 004	4 179	4 362	4 493	4 451
Net margin, %	24%	24%	24%	24%	22%	20%	19%	18%	18%	17%	16%

Source: Company data, RMG estimates

Dividends are high

We note that Gazprom Neft paid the second highest dividends in the Russian oil & gas sector for 2006, and we expect dividends to remain at a high level (matching strong profitability), although there may be some decline as capex levels rise.

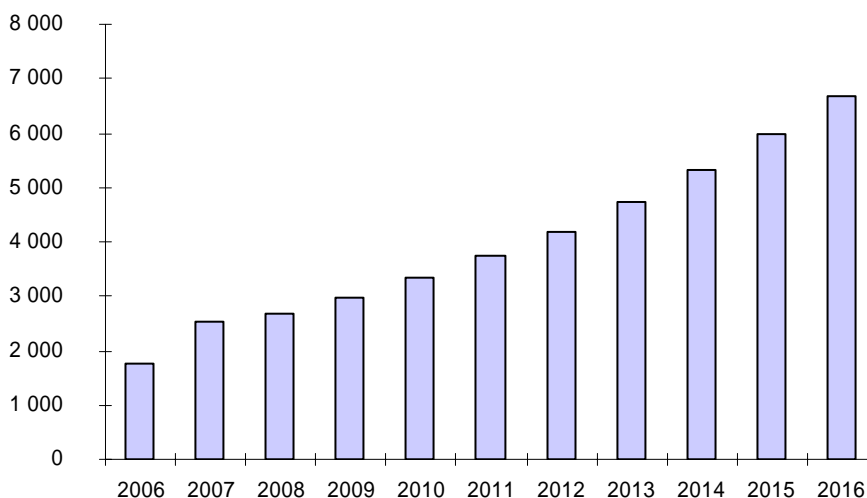
Capex

According to Chairman of the Board of Gazprom Neft, Alexander Dyukov, the company will spend about \$70b in order to reach its production target of 80mt by 2020. Another capex forecast by the company suggests annual investments of \$3.5b-4b in exploration and development of new oilfields in order to achieve the target.

Our capex estimate to 2020 is \$73b

We predict \$73b capex from 2006 to 2020 and reduce production volumes in 2020 to 75mt in order to make the estimate more conservative. We doubt that purchases of licenses for new fields will have significant impact on Gazprom Neft's cash flows (since the licenses will be purchased from the company's parent, Gazprom).

Capex forecast (\$m)



Source: Company data, RMG estimates

Debt is low

Company debt is currently only 11% of debt plus equity, and this should allow the company to raise necessary debt financing in the future for exploration and development of new oil fields.

Valuation

Our key assumptions are WACC of 10.6% and TGR of 3%

We valued Gazprom Neft using DCF. Our key assumptions are WACC of 10.6% and terminal growth rate of 3%. In calculating WACC we use risk-free rate of 5.7%.

Gazprom Neft's beta is very low at 0.6 (according to Bloomberg). Sluggish reaction to market movement reflects the company's small free-float, but we think that Gazprom Neft shares are subject to the same news-flow pressures as other oil stocks and therefore use beta of 1, which is the average level for Russian oil companies. We increase our standard risk premium of 5% to 5.5%, also because of the small free float.

FCFF calculation

	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
EBIT, \$m	4 588	5 871	5 944	5 372	4 725	4 955	5 175	5 406	5 569	5 506
Income tax, 24%	991	1 284	1 290	1 163	1 019	1 085	1 136	1 191	1 231	1 217
Changes in NWC, \$m	116	960	7	-118	-168	442	421	433	438	392
Capex, \$m	2 525	2 674	2 973	3 342	3 747	4 191	4 723	5 313	5 968	3 550
DD&A, \$m	932	1 119	1 316	1 535	1 782	2 059	2 368	2 717	3 109	3 550
FCFF, \$m	1 888	2 072	2 990	2 520	1 910	1 296	1 263	1 186	1 040	3 897
Discount factor	-	1.0	1.1	1.2	1.4	1.5	1.7	1.8	2.0	2.2
Discounted FCFF, \$m	-	2 072	2 704	2 062	1 413	868	765	649	515	1 746

WACC calculation

Cost of debt, %	7.0%
Market value of debt end-2007, \$m	3 326
Tax rate	24.0%
Beta	1.0
Risk free rate	5.7%
Risk premium	5.5%
Cost of equity	11.2%
Share of debt	11%
Share of equity	89%
Market value of shareholders equity, \$m	27 025
Bid, \$	5.6
Ask, \$	5.8
Mid, \$	5.7
# common shares, m	4 741
WACC	10.6%

Source: RTS, RMG estimates

Fair price calculation for the end of 2008

Terminal growth rate, %	3.0%
Terminal value, \$m	58 464
PV of terminal value, \$m	26 196
Discounted value for 2008-2016, \$m	12 795
Fair EV, \$m	38 991
Net debt, \$m	2 623
Fair MC, \$m	36 368
Number of common shares, m	4 741
Common share fair price, \$	7.70

Source: RMG estimates

Conclusion

Our fair price estimate at the end of 2008 is \$7.70

Our fair price estimate for Gazprom Neft suggests that company shares should be worth \$7.70 at the end of 2008, which implies 35% upside from current levels. We recommend investors to BUY the stock, although Gazprom Neft's share price has grown significantly in past months.

Finally, we offer a sensitivity matrix, which shows how variation of WACC and terminal growth rates affect our fair price.

Sensitivity matrix (share price in \$)

		Terminal growth rate				
		1.0%	2.0%	3.0%	4.0%	5.0%
WACC	9.0%	8.0	8.9	10.1	11.7	14.2
	10.0%	6.9	7.6	8.4	9.5	11.0
	10.6%	6.4	7.0	7.7	8.6	9.8
	11.0%	6.1	6.6	7.2	7.9	9.0
	11.5%	5.7	6.1	6.7	7.3	8.2

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